

Nebraska Employee Classification Act

Annual Report
July 1, 2010 – June 30, 2011



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EXECUTIVE SUMMARY

In 2010, the Nebraska Legislature passed the Employee Classification Act (ECA), LB 563, which became operative on July 1, 2010. The act not only designated the Nebraska Department of Labor (NDOL) as the primary enforcement agency, but additionally required NDOL to provide the Legislature with an annual report regarding compliance with and enforcement of the ECA. The report shall include:

1. The number of reports received from both its hotline and website.
2. The number of investigated reports.
3. The findings of the reports.
4. The amount of combined tax, interest, and fines collected.
5. The number of referrals to the Nebraska Department of Revenue, Nebraska Workers' Compensation Court, and appropriate prosecuting authority, and the outcome of such referrals.

NDOL has longstanding corrective practices and regularly assesses misclassification initiatives. The federal government's emphasis on employee misclassification prevention is underscored by new audit measures outlined in the Unemployment Insurance Program Letter (UIPL) 30-10 from the United States Department of Labor (USDOL), requiring state unemployment insurance agencies to align federal and state practices by conducting audit and investigative programs to detect employers that misclassify or fail to properly report compensation to workers with the effect of excluding employees from protections of law. NDOL efforts enforce and deter labor violations that result in the misclassification of employees as "independent contractors". Investigations are particularly directed to industries that have higher rates of violations, such as construction, child care, home health care, grocery stores, janitorial, business services, poultry and meat processing, and landscaping.

To determine proper classification of workers as an employee or independent contractor, the Internal Revenue Service (IRS) and state tax agencies apply common law criteria and controlling state statute to examine the degree of control a company has over that worker. Proper classification entitles "employees" to the protections of wage and hour laws, employment discrimination laws, and unemployment and worker's compensation insurance. The focus on proper classification is also recognized as a revenue-generating measure for federal and state governments. Employers who abide by the law and report quarterly wages and pay unemployment insurance and other taxes owed are put at a competitive tax disadvantage by employers who misclassify workers as "independent contractors".

Misclassification investigations are conducted within two program areas in NDOL:

1. The Classification Unit within the Contractor Registration (CR) Program conducts investigations on reported violations derived from the hotline, website, random worksite visits, and tips received as a result of investigative inquiries.
2. The Unemployment Insurance (UI) Tax program Field Representatives conduct employer wage verification audits. Data from the 1099 extract files for targeted industries identify potential employers for misclassification audit purposes.

Outreach/Education Efforts:

NDOL performs outreach to thousands of businesses and workers to educate them about the ECA, proper classification of employees, and penalty of violation. In conjunction with the requirements of the Contractor Registration Act (CRA), NDOL established and operates a hotline and website for individuals to confidentially report suspected violation of the ECA. In addition, the website provides educational information about misclassification. Other Nebraska state agencies have set up links to the NDOL home page for access to misclassification information, including the Nebraska Department of Revenue (NDOR) and Workers' Compensation Court (WCC). Educational seminars are conducted around the state to increase awareness of the ECA and the requirement for proper classification of an employee under the act.

Unreported Wages, Unpaid Unemployment Insurance Taxes, Penalties & Interest:

Because of current economic conditions and an unemployment rate that is higher than what Nebraska historically has experienced, it is important to ensure all employers properly classify employees and pay their fair share of unemployment insurance tax contributions. Proper payment of unemployment insurance taxes ensures a solvent UI trust fund keeps unemployment tax rates as low as possible. NDOL utilizes IRS 1099 extract files to identify potentially liable Nebraska employers. Focusing on industries with higher rates of violation, UI Tax field representatives perform audits identifying misclassified workers, resulting in the collection of unpaid tax and interest. Unpaid employment taxes bear interest at the rate of 18% per annum. Administrative penalties can be assessed for violations of the ECA.

Referrals, Information-Sharing Between Other State Divisions, Agencies:

After NDOL has completed misclassification investigations, audits, and findings, cases are referred to the NDOR and WCC for investigation and collection of any income tax not withheld plus interest and penalties. Referrals of instances reasonably believed to be civil or criminal violations of the Employment Security Law, the Nebraska Revenue Act of 1967, and the Nebraska Workers' Compensation Act, or another law, are made to the appropriate prosecuting authority for appropriate action. Similarly, those entities share information with NDOL. NDOL has an agreement with the IRS that allows for the transfer of 1099 data related to misclassification.

Coordination with National, Other State Officials: Nebraska shares misclassification information and enforcement strategies with federal labor officials and other states.

I. BACKGROUND AND PURPOSE

Employee Misclassification Defined:

Employee misclassification occurs when a worker is improperly denied the benefits and protections provided to “employees,” as that term is defined by state and federal law. Workers who are classified as employees receive a wide range of legal protections, including eligibility for unemployment insurance benefits if they are laid off, workers’ compensation protection if they are injured on the job, and the right to be paid minimum wage and overtime pay. Employees have the benefits of other employment and labor laws, such as family medical leave and protection under discrimination laws. Employers with employees are required to obtain workers’ compensation insurance, report wages and pay corresponding unemployment insurance taxes, social security, and withhold state and federal income taxes.

There are two primary forms of worker misclassification – characterizing someone as an “independent contractor,” or paying a worker “off-the-books” for work performed.

1. **Misclassification as an independent contractor.** The first form of misclassification occurs when a worker who meets the legal standards for classification as an “employee” under state and federal law is instead misclassified as an “independent contractor.” Nebraska uses several variations of the “common law test” to determine whether an individual is an independent contractor or employee, depending on the program. The CRA and ECA programs primarily use the traditional common law utilized by the IRS. The UI Tax program uses a somewhat more stringent test commonly referred to as the “ABC” test. Many of the relevant factors used to assess “direction and control” for unemployment insurance, workers’ compensation, OSHA, wage and contractor registration purposes are similar to the 20 factors used by the IRS and relied upon by the NDOR. Employers issue their employees a W-2 form at the end of the year. By contrast, workers who are classified as “independent contractors,” are issued a “Form 1099” for tax reporting purposes and the employer is not responsible for unemployment insurance, social security and income taxes, or providing workers’ compensation insurance.
2. **Unreported or “off-the-books” work.** This form of misclassification occurs when employees are paid “off-the-books,” or “under-the-table,” and there is no reporting for social security, income tax, and unemployment insurance purposes. These workers may be employed by employers that do not register with state and federal taxing agencies and do not purchase workers’ compensation insurance. Others may work for employers that register with state and federal taxing authorities, but underreport the number of workers they employ.

In tough economic times, those desperate to just get paid may be attracted to “off the books” or “cash under the table” jobs until the worker discovers they cannot get unemployment insurance benefits when laid off, or workers’ compensation benefits when they are injured on the job, or owe a large income tax bill at the end of the year.

Misclassification Investigative Programs:

The purpose of misclassification investigative programs is to determine if workers are being appropriately classified as “employees” or “independent contractors,” and if there are related tax obligations. Proper classification also affords employees the protections of law. NDOL investigates misclassification in two program areas – CR and UI Tax.

1. Eighteen UI Tax Field Representatives conduct employer audits utilizing a web-based audit process that loads 1099 extract information into an audit application. 1099 data identifies employers who issued between 1 and 50 1099s. Data can be refined to identify specific trades within North American Industry Classification System (NAICS) codes. Particular emphasis is placed on industries, such as transportation and construction trades, who have high employee misclassification violation rates.

The UI Tax division also investigates UI benefit claims that lack wage credits as a means of identifying misclassified workers.

2. The Employee Classification Unit in the CR program investigates possible ECA violations. A misclassification investigation is initiated when workers, businesses, or government agencies provide tips, referrals, or leads. The Employee Classification Unit creates and assigns a file for every valid tip, referral, and lead received. Assigned files are not prioritized and their completion depends upon the complexity of the issues, the level of evidence gathered, and the cooperation of the worker and employer. The investigative determination is based on all available evidence. The employer ultimately receives a determination letter in the mail advising them if workers have been misclassified and if any unemployment insurance taxes, related penalties and interest are owed.

NDOL receives tips, referrals, or leads through the online application on the website, hotline, as a result of general telephone or walk-in inquiries regarding the law. We also conduct employer and worker interviews during random worksite visits.

II. ACCOMPLISHMENTS

The success of proper employee classification is grounded in the careful, detailed investigation and audit process of the Contractor Registration/Classification Unit and UI Tax field representative staff. The investigators are thorough in their observations at the work site, including their interviews with workers and management. Field representatives are diligent in their review of often voluminous and complex financial records. The goal is to gather evidence from all interested parties to ensure a complete picture of the business operation and relationships between the employer and workers.

Outreach and Education: Through the CR and UI Tax programs, NDOL staff conduct field audits, random worksite visits, interviews, and provide educational information on ECA and the penalty of violation to employers and workers. Informational materials have been developed and distributed statewide.

Website and Hotline: The ECA requires NDOL to maintain a website providing general information regarding ECA, narrative of the law, links to required postings (English and Spanish versions), and the ECA Report Form, allowing for the confidential reporting of suspected violations of employee classification. The website was implemented in July 2010 and is located on the NDOL website at <http://www.dol.nebraska.gov/center.cfm?PRICAT=3&SUBCAT=5M>. The website provides staff contact information to allow employers and workers direct access Contractor Registration and Classification Unit program staff. A 1-800 Hotline was established to allow for reporting suspected violations of the ECA. The website features links to sources of information regarding worker misclassification, including contractor registration, the WCC, NDOR, and the IRS (SS-8 Determination of Status Form).

Brochures and Notices: More than 4,000 Contractor Registration/Employee Classification Act brochures were distributed statewide. The brochures include:

- ✓ Basic information on contractor registration
- ✓ Instructions for reporting suspected violations of the ECA
- ✓ UI and IRS contact information

The Employee Classification Act Notice is required to be posted at all jobsites. More than 3,100 notices have been distributed to date. All brochures and notices are available online <http://www.dol.nebraska.gov/center.cfm?PRICAT=3&SUBCAT=5M> and have been provided to employers and workers at 26 presentations and 376 onsite inspections this past year.

The Employee Classification Act Report Form: The ECA Report Form allows individuals to report suspected misclassification violations. The individual or entity completing the form may remain anonymous. The form requires the reporting individual to provide contact information, a description of the suspected violation, the name of the business and job site location. The form is located at <http://www.dol.nebraska.gov/center.cfm?PRICAT=3&SUBCAT=5M>.

Contractor Registration/Employee Classification Unit: Each Contractor Registration/Employee Classification investigator is required to perform a minimum of 100 on-site inspections annually. Contractor registration investigators conducted 376 onsite construction inspections in FY 2010-2011. They also conducted interviews with 8 walk-in customers who had questions regarding the law, none of which resulted in an active investigation. Each worksite is checked and employers and workers are interviewed for possible misclassification violations. Many times employers found to be misclassifying workers provide the names of other employers who are engaged in the same illegal practice. Tips also come from businesses who are underbid by competitors whom they suspect of being engaged in misclassification.

The Contractor Registration Program yielded 31 misclassification inquiries through the online application. Inquiries were initiated due to the contractor providing inaccurate or incomplete information. Nebraska's CRA requires that eligible contractors provide proof of workers' compensation insurance and provide a valid unemployment insurance tax ID number when they

register or renew. Each registration or renewal is checked for compliance with unemployment insurance tax law. For new registrations staff works with the new employer to educate them about correct wage reporting, payment of unemployment insurance taxes, and proper employee classification. This activity puts the employer on the right path from the start and discourages improper classification of employees.

A total of 26 presentations have been given since September 2010, with up to fifty participants at each event. Participants include construction contractors, accountants, payroll processors, human resource professionals, attorneys, and employers and workers in various industries and organizations. Outreach is a shared venture with the NDOR. Presentations focus on emphasizing the fact that it is a violation of the ECA to designate an individual as an independent contractor who would be properly classified as an employee. Fines and penalties are reviewed. Each presentation encourages questions and includes how to confidentially report suspected misclassification.

For the reporting period of July 1, 2010 – June 30, 2011, the Contractor Registration/Employee Classification Unit received 59 online misclassification report forms resulting in 39 inquiries. Staff received an additional 287 telephone inquiries regarding the law. Investigators within the Contractor Registration/Employee Classification Unit created 31 leads from random worksite visits resulting in an additional 8 inquiries. There are currently 26 open investigations including 12 cases with citations pending.

Approximately 40 reports of possible misclassification were received that did not fall under the legal requirements of the ECA.

All misclassification reports were forwarded to the NDOL UI Tax Division, the NDOR, and WCC.

The Contractor Registration/Employee Classification Unit received 26 referrals from the NDOL UI Tax field representatives.

During the reporting period, 22 (\$500 fine) Contractor Registration citations were issued. Two were paid in full, 7 were paid at reduced rates, 6 were withdrawn, and 7 are pending further collection action. No appeals were filed on the citations issued.

Unemployment Tax Field Representative Audit Program: The field tax representatives in NDOL's UI Tax division provide education and services to more than 48,000 employers who report wages quarterly and pay related unemployment insurance taxes. Field representatives also work with new employers to ensure they get unemployment insurance accounts set up correctly when they start business and understand their quarterly reporting and unemployment insurance tax payment obligations. The correct classification of workers is discussed with employers when the new unemployment accounts are set up. Similarly, if an employer attempts to inactivate their

unemployment account, field representatives ask the necessary questions to determine if the employer downsized their business or is attempting to misclassify workers as independent contractors.

In addition, field representatives also assist contractors who are registering for a contractor registration certificate, taking the time during the application process to educate employers on the differences between an independent contractor and an employee.

The UI Tax field representatives conduct two kinds of audits that may lead to discovery of misclassification – “1099 extract audits” and “obstructed claim investigations.” “1099 extract audits” target employers who are registered in the unemployment insurance system but also issue 1099s. “Obstructed claim investigations” occur when a worker files for unemployment benefits and it is discovered the worker’s alleged employer did not report wages, and pay corresponding unemployment taxes, related to the worker, and other workers in the same classification, because he or she was an alleged “independent contractor.”

From July 1, 2010 – June 30, 2011, UI Tax field representatives completed 938 audits and missing wage investigations. Of those, 669 field audits targeted high violation industries identified in the 1099 data extract file as described above, resulting in 1,039 misclassified workers and additional tax collections of \$42,559.24.

The table below shows quarterly audit results from 1099 extracts from July 1, 2010 – June 30, 2011:

Reporting Period July 1, 2010 – June 30, 2011	# of Audits from 1099s	Misclassified Workers	Additional Tax Collected
3 rd Q 2010	62	94	\$ 5,440.58
4 th Q 2010	129	227	\$ 7,233.67
1 st Q 2011	231	473	\$17,649.00
2 nd Q 2011	247	245	\$12,235.99
Total:	669	1039	\$42,559.24

Numbers are consistent with previous reporting periods. See Attachment for historical data.

Regarding obstructed claim investigations (UI benefit claims that have no wage credits), UI Tax field representatives identified 103 misclassified workers, resulting in \$11,607.32 in tax collections.

UI Tax field representatives identified and referred 32 unregistered construction businesses to Contractor Registration resulting in 32 new registrations and \$1,280.00 in contractor registration fees.

The UI Tax collections unit works with employers to collect the unpaid taxes and sets up payment plans as appropriate.

III. COLLABORATION WITH STATE AND FEDERAL AGENCIES

The Contractor Registration/Employee Classification Unit staff works cooperatively with other agencies/divisions, including the NDOL UI Tax Division, NDOR and WCC, Homeland Security, and Occupational Safety and Health (OSHA). Staff has also on occasion collaborated with the Iowa Department of Labor's Misclassification Unit, and USDOL.

Over the past 18 months, much progress has been made in coordinated enforcement effort. In January 2010, NDOR merged their database with NDOL's Contractor Registration database, allowing for the sharing of contractor registration and misclassification-related information.

Nebraska Department of Labor - Contractor Registration: Nebraska law requires that all contractors seeking registration with NDOL provide proof of workers' compensation insurance, if they have employees. Employers are also asked to provide their valid unemployment tax ID at the time of registration. A \$40 fee must be submitted with the contractor registration application, unless the contractor meets fee exemption requirements. There are 13,717 registered contractors in our database, nearly 3,000 of which are fee exempt and claiming "0" employees.

Contractor Registration/Employee Classification Unit staff and UI Tax field representatives play a critical role in processing contractor registration applications by reviewing the submitted applications to determine if the contractor is obligated to report quarterly wages and pay unemployment taxes. The purpose is to inform all contractors of wage reporting and unemployment tax obligations up front.

Nebraska Workers' Compensation Court: NDOL Contractor Registration/Employee Classification Unit and UI field representatives provide the WCC with information about employers who have been found to have engaged in misclassification. The WCC reviews the information and takes appropriate steps to determine if the employer is providing workers' compensation coverage as required under Nebraska law.

Nebraska Department of Revenue: After NDOL has completed misclassification investigations, audits, and findings, cases are referred to the NDOR and WCC for investigation and collection of any income tax not withheld plus interest and penalties. Referrals of violations reasonably believed to be civil or criminal of the Employment Security Law, The Nebraska Revenue Act of 1967, and the Nebraska Workers' Compensation Act, or another law, are made to the appropriate prosecuting authority for appropriate action. Similarly, those entities share information with NDOL. NDOL has an agreement with the IRS that allows for the transfer of 1099 data related to misclassification.

Internal Revenue Service: The UI Tax division has a Questionable Employment Tax Practices (QETP) agreement in place with the IRS that allows for data-sharing of misclassification cases. The agreement allows NDOL to receive copies of IRS audit findings of Nebraska businesses that reflect potential misclassification of workers for state unemployment tax purposes. Each quarter, NDOL submits QETP data back to the IRS reporting on all audits that were generated by the 1099 extract program, the results of the audits, and the number of misclassified workers that were reclassified as employees.

IV. OTHER EFFORTS

Nebraska's 1099 audit process has been in use since 2002. Its success in identification of misclassified workers is recognized by USDOL and officials in other states. Nebraska has been invited to present effective methods to detect and deter misclassified workers at the National Unemployment Insurance Directors' Conference and IT/Legal Issues Forum in Providence, RI on October 17, 2011.

V. CONCLUSION

NDOL's Contractor Registration/Employee Classification Unit staff and UI Tax field representatives educate businesses and workers about the dangers of misclassification and take appropriate enforcement action to protect Nebraska's workers and law-abiding businesses. Our Contractor Registration and investigative programs determine if workers are being appropriately classified as "employees" or "independent contractors". We make referrals to NDOR, WCC, and appropriate prosecuting authority; the outcome of such referrals ensure the collection of required taxes, interest and penalties, and afford employees the protections of law.

Historical Data
Audit Activity 2002 – 2011

Quarter/Year	# of Audits From 1099's	# Of Workers Misclassified	Additional Tax Collected
4/02	55	108	\$ 20,210.00
1/03	60	76	\$ 5,190.00
2/03	24	26	\$ 3,230.00
3/03	33	22	\$ 12,918.14
4/03	25	45	\$ 1,727.29
1/04	111	95	\$ 7,210.55
2/04	39	15	\$ 2,495.20
3/04	347	15	\$ 1,634.55
4/04	125	155	\$ 9,136.74
1/05	102	134	\$ 3,271.51
2/05	9	39	\$ 286.92
3/05	57	115	\$ 1,169.12
4/05	67	90	\$ 3,666.00
1/06	184	177	\$ 11,701.64
2/06	23	58	\$ 2,227.16
3/06	51	41	\$ 1,421.30
4/06	64	31	\$ 2,198.02
1/07	162	76	\$ 8,006.03
2/07	75	160	\$ 2,538.08
3/07	37	31	\$ 396.66
4/07	115	98	\$ 9,065.08
1/08	146	125	\$ 11,951.93
2/08	75	84	\$ 2,729.65
3/08	66	114	\$ 1,752.41
4/08	137	75	\$ 3,456.45
1/09	157	206	\$ 10,160.91
2/09	93	74	\$ 3,019.88
3/09	46	228	\$ 4,886.67
4/09	122	252	\$ 10,169.65
1/10	53	110	\$ 4,449.21
2/10	77	95	\$ 4,904.16
3/10	62	94	\$ 5,440.58
4/10	129	227	\$ 7,233.67
1/11	231	473	\$ 17,649.00
2/11	247	245	\$ 12,235.99
Totals	3406	4009	\$ 209,740.15